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No. 360

In the Supreme Court of the United States

OCTOBER TERM, 1960

AMERICAN STATE BANK, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINIONS BELOW

The findings of fact and opinion of the District Court (R. 6a-18a)[1] are reported at 176 F. Supp. 64. The opinion of the Court of Appeals (Pet. 26-36) is not yet officially reported.

JURISDICTION

The judgment of the Court of Appeals was entered on June 13, 1960. (Pet. 37.) The petition for a

[1] Record references are to the appendix to the taxpayer's brief as filed in the Court of Appeals.

writ of certiorari was filed on August 24, 1960. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the additions to taxpayer's reserve for bad debts as allowed by the Commissioner under the authority of Section 23(k)(1) of the Internal Revenue Code of 1939 and Section 166(c) of the 1954 Code are reasonable and adequate.

STATUTES AND OTHER AUTHORITIES INVOLVED

Section 23(k)(1) of the Internal Revenue Code of 1939; Section 166(c) of the Internal Revenue Code of 1954; Section 39.23(k)-5 of Treasury Regulations 118; Section 1.166-4 of Treasury Regulations (1954 Code); Mim. 6209, 1947-2 Cum. Bull. 26; Rev. Rul. 54-148, 1954-1 Cum. Bull. 60; Rev. Rul. 57-350, 1957-2 Cum. Bull. 144 are set forth in the Appendix, *infra*, pp. 12-19.

STATEMENT

The material facts as stipulated (R. 21a-30a, 36a-38a) and found by the District Court (R. 8a-11a) may be summarized as follows:

The taxpayer, American State Bank, was organized as a banking corporation under the laws of Wisconsin in 1931. Its sole place of business is in the City of Milwaukee, Wisconsin, at a downtown location to which it moved in 1947. (R. 8a.)

Beginning with the year 1945, the taxpayer, with the consent of the Commissioner, has used the reserve method of accounting for bad debts for federal income tax purposes. (R. 8a.) The deductions claimed by the taxpayer for 1953-1955 as additions to the reserve, and the loss ratios on which such additions were based, were (R. 8a):

1953	$ 42,392.16	.3679%
1954	95,640.84	.9326%
1955	81,576.62	.9226%

The deductions ultimately allowed as additions to the reserve by the Commissioner and the respective loss ratios were (R. 8a):

1953	$ 30,087.80	.11808%
1954	14,957.15	.2608%
1955	23,512.74	.2608%

The taxpayer's net uninsured loans outstanding for the years 1953, 1954, and 1955, respectively, were $11,482,107.69, $12,624,493.02, and $14,427,460. The taxpayer's net charge-offs for the same years, respectively, amounted to $32,834.48, ($2,894.49), and $3,004.77, while its reserves for bad debts as of January 1 of each of the years 1953, 1954, 1955, and 1956, were respectively $53,754.78, $51,000, $68,850, and $89,350. The amounts shown for the last three dates are approximate amounts arrived at by charging the excess of allowed additions over net charge-offs. (R. 9a.)

The taxpayer is a member bank of the Seventh Federal Reserve District. The Marshall & Ilsley Bank and the Bank of Commerce may be considered

comparable to the taxpayer in location and nature of loans. Loss ratios of these banks for the relevant years were as follows (R. 10a):

Year	The Taxpayer	Seventh Federal Reserve District Member Banks	Marshall & Ilsley Bank	The Bank of Commerce
1928	Not in existence	0.329%	.29179%	.3290%
1929	" " "	.554	.37490	.5544
1930	" " "	.563	.60530	.0000
1931	.0.000%	1.306	1.05720	.0260
1932	0.000	2.565	1.69307	3.9820
1933	0.000	6.475	.57182	(.0403)
1934	.610	3.625	2.23646	.7771
1935	1.355	1.570	5.12096	2.9305
1936	(.297)	.870	1.71450	7.0405
1937	.005	(.181)	.49956	2.1211
1938	.232	.009	.49085	.5904
1939	.033	(.034)	.77021	.1291
1940	.158	(.139)	.11844	(.1417)
1941	.110	(.095)	(.32958)	.3753
1942	.446	(.177)	(.2573)	.3834
1943	(.079)	(.307)	.00754	.0530
1944	(.105)	(.177)	.07627	.3522
1945	(.026)	(.135)	(.14084)	.0845
1946	.010	(.018)	.02363	(.0094)
1947	.009	.053	.00942	.0616
1948	.139	.068	Not available	Not available
1949	(.002)	.099	" "	" "
1950	.038	(.025)	" "	" "
1951	.011	.005	" "	" "
1952	.048	.004	" "	" "
1953	.286	.035	" "	" "

To determine additions to reserve for the year 1953, the taxpayer used a loss ratio based on the 20-year period ending with its taxable year and substituted the bad debt loss experience of member banks of the Seventh Federal Reserve District for the years 1934, 1935, and 1936. (R. 11a.)

For the years 1954 and 1955, the taxpayer used the 20-year period from 1928 through 1947 and substituted the Seventh Federal Reserve District percentage for the years 1928 through 1936. (R. 11a.)

The Commissioner disallowed deductions to the extent that they were based on substituted loss ratios for the years the taxpayer was in actual existence. (R. 11a.) On the basis of the facts of record, the District Court sustained the Commissioner's determinations (R. 11a-18a) and the Court of Appeals affirmed (Pet. 26-36).

ARGUMENT

The decision here turns on the facts of the particular case, there is no conflict, and no other reason exists for further review by this Court.

1. Under the provisions of Section 23(k)(1) of the 1939 Code, a taxpayer is allowed a deduction in computing net income for "Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; * * *." Section 166(c) of the 1954 Code is to the same effect.[2] The taxpayer elected in 1945 to use the so-called "reserve method" of computing its deductions under these sections of the Codes in lieu of a deduction for specific debt items which become worthless during the taxable years.

[2] For convenience, specific reference hereafter will be made only to the 1939 Code section.

As the Court of Appeals observed (Pet. 34), a taxpayer utilizing the reserve method for bad debt deductions submits himself to the reasonable discretion of the Commissioner. Repeatedly, the courts have stated that the taxpayer has a "heavy burden" of proving that the Commissioner, in disallowing a part of the addition to the reserve claimed by the taxpayer, abused the broad discretion specifically granted to him by Congress. See, for example, *Maverick-Clarke Litho Co.* v. *Commissioner*, 180 F. 2d 587, 592 (C.A. 5th); *Morris Plan Ind. Bank* v. *Commissioner*, 151 F. 2d 976 (C.A. 2d); *Art Metal Const. Co.* v. *United States*, 17 F. Supp. 854 (C. Cls.). Consistent with this standard, the Court of Appeals, affirming the trial court, held that the taxpayer failed to prove that the Commissioner acted arbitrarily and unreasonably in the instant case. (Pet. 35-36.) This holding, we submit, is correct.

What constitutes a reasonable addition to a reserve for bad debts, regardless of formula, must be determined upon the facts and circumstances of a particular class of business and with relationship to the conditions of business prosperity. *S. W. Coe & Co.* v. *Dallman*, 216 F. 2d 566 (C.A. 7th); *Black Motor Co.* v. *Commissioner*, 41 B.T.A. 300, 304, affirmed, 125 F. 2d 977 (C.A. 6th); Treasury Regulations 118, Sec. 39.23(k)-5; Treasury Regulations on Reserve for Bad Debts (1954 Code), Sec. 1.166-4. Section 39.23 (k)-5 of Treasury Regulations 118 (Appendix, *infra*, pp. 12-13) further provides that a reasonable addition to a reserve for bad debts "will depend primarily upon the total amount of debts outstanding as of the

close of the taxable year, those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve." Section 1.166-4 of the 1954 Code Treasury Regulations (Appendix, *infra*, p. 13) is to the same effect. The reserve itself must be adequate to absorb the bad debts that might probably arise. *Krim-Ko Corp.* v. *Commissioner*, 16 T.C. 31; *Newlin Machinery Corp.* v. *Commissioner*, 28 T.C. 837.

The Commissioner, pursuant to the discretion given him by Congress, has approved the use by commercial banks of a method of computing deductions for reasonable additions to a reserve for bad debts under Section 23(k)(1) of the Code and the Regulations promulgated thereunder. Mim. 6209, 1947-2 Cum. Bull. 26 (Appendix, *infra*, pp. 13-16). In this ruling, the Commissioner has set forth a formula which provides for additions to the reserve based upon the average ratio, over a 20-year period ending with the taxable year, of bad debt losses to loans outstanding at the close of the year. Mim. 6209 permitted newly organized banks and banks without sufficient years' experience of their own to set up a reserve commensurate with the experience of similar banks but expressly subjecting such supplementation to adjustment after a period of years when the bank's own experience was established.

For tax years beginning after December 31, 1953, the Commissioner, in Rev. Rul. 54-148, 1954-1 Cum. Bull. 60 (Appendix, *infra*, pp. 16-18), supplemented Mim. 6209 and approved, as an alternative method for the computation of reasonable additions to a bad

debt reserve, the use of an average experience factor based upon a bank's experience over any 20 consecutive year period after 1927. Consistent with the provisions of Mim. 6209, Rev. Rul. 54-148 provided that a bank which selected a 20-year period extending back into years for which it had no experience would be permitted to fill in such years with similar comparable data. The Commissioner amplified the rulings in Rev. Rul. 57-350, 1957-2 Cum. Bull. 144 (Appendix, *infra*, pp. 18-19), and further explained that for the portion of the 20-year period selected during which the bank was in existence it would be required to use its own experience, and that for the portion the bank was not in existence it would be permitted to supplement its own experience with the bad debt experience of similar banks.

The nub of the instant controversy is that, although the taxpayer recognizes the formulae used to derive the reasonable additions allowed by the Commissioner, in order to obtain a greater deduction the taxpayer wishes to modify the formulae by substituting loss ratios of other banks for its own experience during years it was in actual existence. (R. 11a.) The Commissioner disallowed the taxpayer's deductions to the extent that the additions to the reserve were based upon substituted experience for the years the taxpayer was in existence and had its own experience. (Pet. 30.) The Commissioner's determinations were sustained by the courts below.

The taxpayer claims (Pet. 10) that the additions allowed it were unreasonable because they were not as great as those of two comparable downtown Mil-

waukee banks nor as great as those of the Seventh Federal Reserve District member banks, and that such treatment is prejudicial discrimination. The Court of Appeals, in a detailed review of the evidence (Pet. 32-33), found substantial support for the District Court's findings of fact that the loss experience of the two downtown banks did not support a reasonable expectation of substantially increased bad debt losses on the part of the taxpayer, and further found that the substituted experience of the Seventh Federal Reserve District member banks was without pertinent relevancy to the taxpayer's circumstances, the nature of its outstanding loans, its loan policy, or its anticipated loss. In addition, it found nothing to support a finding of present or anticipated future losses which would establish the insufficiency of the allowed additions to reserves or the inadequacy of accumulated reserves. Rather the reserves had been completely sufficient and, in fact, during the taxable years the ratio of the reserve for bad debts to total loans increased substantially.[7] (Pet. 33.) Based upon these and other facts of record, the court below held that the Commissioner's determinations of the allowable additions to the reserve for the taxable years were reasonable and adequate, and that the Commis-

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[7] Contrary to the taxpayer's argument (Pet. 11-16), in discussing an exception for excess profits tax purposes to the bad debt reserve method permitted under Mim. 6209, the congressional reports cited by the taxpayer recognize the validity of the principle and practice under Mim. 6209. The excess profits tax exception is, of course, without pertinency here.

sioner had not abused his discretion. These holdings are correct, are of a factual nature, and do not warrant further review.

2. The taxpayer's claim (Pet. 8, 12-13) that the decision of the court below is in "direct" conflict with two Court of Claims cases is totally without merit. Neither case concerns reasonable additions to reserves for bad debts for commercial banks or any other business nor do they concern the application of the Commissioner's discretion under Section 23(k)(1). In *Exchange Parts Co. of Fort Worth* v. *United States*, 279 F. 2d 251, a case concerning excise taxes on sales of rebuilt generators and clutch assemblies, the Court of Claims did not give effect to the retroactive feature of a ruling changing a prior position, where that aspect of the ruling was applicable solely to taxpayers who had paid the tax. Similarly, in *Connecticut Railway and Lighting Co.* v. *United States*, 142 F. Supp. 907, the Court of Claims deemed the retroactive aspect of a reversal in position in a ruling to be invalid and prejudicially discriminating where the retroactivity was limited solely to taxpayers who had paid their tax. In no wise was there a retroactive change involved in the instant case; rather, there was a continuing liberalization of what is considered reasonable within the meaning of the pertinent statutes.

Not only is there no conflict but the decision below sustaining the Commissioner's action is in complete accord with *First National Bank of La Feria* v. *Commissioner*, 234 F. 2d 868 (C.A. 5th), a case

directly in point on the application of the formula set forth in Mim. 6209. The Fifth Circuit affirmed the Tax Court's findings (24 T.C. 429) that since that taxpayer had been in existence during the years it desired to substitute another bank's experience, and since that taxpayer's actual bad debt losses for the years in question were more in line with its own moving average ratios based on its own bad debt experience, it was improper to use the experience of a substituted bank instead of its own.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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SEPTEMBER, 1960

APPENDIX

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(k) *Bad debts.*—

(1) *General rule.*—Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; * * *

* * * * *

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

SEC. 166. BAD DEBTS.

(a) *General rule.*—

* * * * *

(c) *Reserve for bad debts.*—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

* * * * *

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

SEC. 39.23(k)-5. *Reserve for bad debts*—(a) * * * (2) What constitutes a reasonable addition to a reserve for bad debts must be determined in the light of the facts, and will vary as between classes of business and with conditions of business prosperity. It will depend primarily

upon the total amount of debts outstanding as of the close of the taxable year, those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve. * * *

Treasury Regulations under the Internal Revenue Code of 1954:

SEC. 1.166-4. *Reserve for bad debts.* * * *

(b) *Reasonableness of addition to reserve.*— (1) *Relevant factors.* What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve.

* * * * *

Mim. 6209, 1947-2 Cum. Bull. 26:

1. The Bureau has given careful and extended consideration to the situation of banks in general with respect to the use of reserves for bad debts, the proper measure of such reserves, and amounts to be allowed as deductions.

2. In determining a reasonable annual addition to a reserve for bad debts by a bank it is believed to be fair and sufficiently accurate to resort to the average annual bad-debt loss of the bank over

a period of 20 years, to include the taxable year, as constituting a representative period in the bank's history and to accept the equivalent percentage of presently outstanding loans as indicative of the probable annual accruing loss. The Tax Court has held that the "use of the reserve for bad debts is not inherently inconsistent with a cash basis where, as here, the reserve is against loss of capital only * * * and contains no element of income which has never been reported. * * * Such a reserve for loss of capital does not differ materially from a reserve for depreciation which is set up on a percentage basis rather than on the basis of actual depreciation suffered." (See *Estate of Maurice S. Saltstein* v. *Commissioner*, 46 B.T.A. 774, 777, acquiescence, C.B. 1942-1, 14.) However, such reserve cannot be permitted to accumulate indefinitely simply because of the possibility that at some future date large losses may be concentrated within a relatively short period of time and operate to absorb the greatest probable reserve. To permit this would sanction the deduction of a mere contingency reserve for losses, which is not an allowable deduction for income or excess profits tax purposes. This latter rule makes imperative the imposition of some reasonable ceiling on the accumulation of the reserve other than such indefinite limitation as might eventually prevail under a moving average method.

3. The Bureau has accordingly approved the use by banks of a moving average experience factor for the determination of the ratio of losses to outstanding loans for taxable years beginning after December 31, 1946. Such a moving average is to be determined on a basis of 20 years,

including the taxable year, as representing a sufficiently long period of a bank's experience to constitute a reasonable cycle of good and bad years. The percentage so obtained, applied to loans outstanding at the close of the taxable year, determines the amount of permissible reserve in the case of a bank changing to the reserve method in such year (see first year in following computation) and the minimum reserve which the taxpayer will be entitled to maintain in future years (see second year in following computation). A bank, following a change to the reserve method of accounting for bad debts, may continue to take deductions from taxable income equal to the current moving average percentage of actual bad debts times the outstanding loans at the close of the year, or an amount sufficient to bring the reserve at the close of the year to the minimum mentioned above, whichever is greater. Such continued deductions will be allowed only in such amounts as will bring the accumulated total at the close of any taxable year to a total not exceeding three times the moving average loss rate applied to outstanding loans (see fifth year in following computation).

Example of the application of foregoing with amount of outstanding loans remaining unchanged at $1,000,000

Year	Moving average percentage	Actual bad debts for year	Deduction	Reserve at end of year	Ceiling
1	1.0	$ 2,000	$12,000	$10,000	$30,000
2	.8	11,500	9,500	8,000	24,000
3	.7	1,000	7,000	14,000	24,000
4	.8	1,000	8,000	21,000	24,000
5	1.0	500	9,500	30,000	30,000

* * * *

5. A newly organized bank or a bank without sufficient years' experience for computing an average as provided for above will be permitted to set up a reserve commensurate with the average experience of other similar banks with respect to the same type of loans, preferably in the same locality, subject to adjustment after a period of years when the bank's own experience is established.

* * * *

Rev. Rul. 54-148, 1954-1 Cum. Bull 60:

Sec. 1. Purpose.

The purpose of this Revenue Ruling is to supplement Com.-Mimeograph Coll. No. 6209 dated December 8, 1947 (C.B. 1947-2, 26), which authorizes, in the case of banks, a special method for computing a reasonable addition to the reserve for bad debts under section 23(k)(1) of the Internal Revenue Code and the regulations promulgated thereunder.

Sec. 2. Background.

The Service has carefully reexamined the provisions of Mimeograph 6209, *supra*, in the light of experience developed thereunder and, as a result of such reexamination, has approved an alternative method for the use of banks in computing the annual addition to the reserve for bad debts and the maximum amount permitted to be accumulated in such reserve, as set forth in section 4 hereunder.

* * * *

Sec. 4. Alternative Method.

.01 In lieu of the moving average experience factor provided in paragraph 3 of Mimeograph 6209, which is determined on a basis of 20 years including the taxable year, a bank may use an average experience factor based on any 20 consecutive years of its own experience after the year 1927. Such average experience factor representing the percentage of bad debt losses to loans for the period selected, applied to loans outstanding at the close of the taxable year, determines the maximum permissible addition to the reserve for the year.

.02 The amounts permitted to be added in each taxable year to the bad debt reserve under (.01) above may not exceed an amount which will bring the accumulated total in the bad debt reserve at the close of the taxable year to a ceiling equal to three times the average experience factor applied to outstanding loans: * * *.

.03 Consistent with the provisions of Mimeograph 6209 which permit newly organized banks and banks without sufficient years' experience of their own to set up a reserve commensurate with the average experience of other similar banks with respect to the same type of loans, preferably in the same locality, banks which select a 20-year period under (.01) above which extends back into years for which they have no experience of their own will be permitted to fill in such years with similar comparable data.

* * * *

Sec. 5. Effect on Other Documents.

This Revenue Ruling merely supplements Mimeograph 6209 by providing an additional or alter-

native method for computing the annual addition to a reserve for bad debts and the maximum amount permitted to be accumulated in such reserve. Banks which are now using the moving average method provided in Mimeograph 6209 may continue to use that method if they so desire, and such method is still available to any other banks using or changing to the reserve method of accounting for bad debts.

* * * *

Rev. Rul. 57-350, 1957-2 Cum. Bull. 144:

In Revenue Ruling 54-148, C.B. 1954-1, 60, an alternative method of computing additions to a reserve for bad debts was approved for use by banks in lieu of the 20-year moving average method authorized in Mimeograph 6209, C.B. 1947-2, 26. Such alternative method contemplates that each bank using the reserve method of accounting for bad debts may select any 20 consecutive years after the year 1927 as an experience factor base, regardless of whether the bank was in existence, and therefore had experience of its own, for all or part of the 20-year period selected. For that portion of the 20-year period selected during which the bank was in existence, it is required to use its own experience. For that portion of the 20-year period selected during which the bank was not in existence, section 4.03 of Revenue Ruling 54-148, *supra*, permits a bank to fill in such years with the bad debt experience of other similar banks with respect to the same type of loans, perferably in the same locality. Thus, for example, a bank with continuous existence since December 31,

1933, may select the period 1930 through 1949, use its own bad debt experience for the years 1934 through 1949, and fill in the years 1930 through 1933 with the bad debt experience for those years of other similar banks, preferably in the same locality.

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